STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
(PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
TELEPHONE (916) 324-2642
FAX (916) 323-3387
www.boe.ca.gov

JOHAN KLEHS
First District, Hayward

DEAN ANDAL
Second District, Stockton

CLAUDE PARRISH
Third District, Torrance

JOHN CHIANG
Fourth District, Los Angeles

KATHLEEN CONNELL
State Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

March 17, 2000

RE: Long-Term Lease for

Dear Mr. :

This is in reply to your letter to Assistant Chief Counsel Larry Augusta dated February 18, 2000 regarding the reappraisal of real property located at in due to the execution of a long-term lease of the property.

As discussed further below, it is our opinion that the execution of this lease resulted in a change in ownership and reappraisal of the property, despite the "Option to Terminate" provision in the lease.

Factual Background

As detailed in your letter and the accompanying lease documents, your client, LLC ("Office"), is the lessee of a long-term lease, which was entered into in December 1998 with , Inc. ("C ") as the lessor. The lease is for property in San Mateo and has a term of approximately 69 years, expiring on December 31, 2067. Section 3.2 of the lease agreement, however, provides Office with an option to terminate the lease on or before June 30, 2001 if (1) Office has not obtained final, non-appealable governmental approvals regarding site and building plans and environmental reports, or (2) Office is unable to obtain satisfactory financing for the construction of the project.

Law and Analysis

Revenue and Taxation Code section 60[1] defines "change in ownership" as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." Subdivision (c) of section 61 states in part that change in ownership includes

> (1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a

[1] All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options), and any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal options); or

(2) any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years. . . .

Under the terms of the foregoing provisions, a change in ownership occurs upon the creation of a leasehold interest for a term of 35 years or more, including written renewal options existing at the time of the creation of the lease. Subdivision (c) of section 61 is based upon the recognition that a long-term lease serves as the means of conveying the equivalent of a fee interest in property to a lessee. In addition, subdivision (c) of section 61 also reflects the need for an assessor to identify one primary owner of a property.

It is your belief that the property should not be subject to reappraisal as the lease is contingent upon the start of new construction. The key provision of the lease agreement, in your view, is the "Option to Terminate" in Section 3.2 of the agreement. This section states in part that

> <u>Tenant shall have the option to terminate</u> this Lease (the "Option to Terminate") in the event Tenant has not obtained final, non-appealable Governmental Approvals as provided in Section 6.1 below, or in the event Tenant is unable to obtain satisfactory financing for the construction of the Project <u>in Tenant's sole discretion</u>, on or before June 30, 2001. [Emphasis added.]

In our view, the Option to Terminate does not change the fact that a leasehold interest for a term of 35 years or more was created at the time of the lease's execution in December 1998.

There are three basic factors to be evaluated in determining the length of a leasehold estate: (1) the duration of the lease term expressed in the agreement; (2) the beneficial interest in the property transferred and/or held as provided for in the agreement; and (3) the obligations created by the options provided in the agreement.

With respect to the first factor, the original lease term recited in the lease, including any renewal options, is the most important factor. If the original lease term expressed in the agreement is for 35 years or more, then the assessor should presume that a change in ownership upon the creation of the lease, because the lessee is statutorily considered to be the owner of the property, per subdivision (c) of section 61 as mentioned above. Conversely, per subdivision (c) of section 61, if the term of a lease is for a term of less than 35 years, then there is no presumption of a change in ownership upon the creation of the lease, since the lessor is considered to be the owner of the property.

According to Section 3.01 of the lease agreement, the term of the lease runs from December 10, 1998, the "Lease Date" per the Lease Summary, until December 31, 2067. The express term of the lease is approximately 69 years. If Office decides not to exercise the option to terminate the lease during the first two and one-half years of the lease, whether or not it has obtained final governmental approvals or satisfactory financing by that time, the remaining term of the lease will be sixty-six and one-half years. Consequently, Office received a leasehold estate of 69 years from the day the lease was executed.

With respect to the second factor, the assessor determines pursuant to sections 60 and following who owns the present beneficial interest in a property based on all of the facts available. The present beneficial interest in a property vests in only one primary owner who possesses the rights that are substantially equal to the value of the fee interest. Here, Office acquired a leasehold interest for 69 years and it holds all incidents of ownership in the property for change in ownership purposes. Office took possession of the property and assumed all obligations with respect to the property upon the execution of the lease. During the initial two and one-half year lease period, Office must pay property taxes, insurance, and meet other obligations commensurate with ownership. Office is therefore acting as the owner of the property during this stage of the lease. The fact that Office may decide to exercise the option to terminate does not reduce its leasehold estate in the property during this period of time.

Office's failure to gain satisfactory financing or the requisite governmental approvals by June 30, 2001 does not automatically terminate the lease. Office, as the lessee of the property, may or may not choose to terminate the lease if these events have not occurred. As such, Office has exclusive control of the property and C is without power to act under the lease, resulting in the present beneficial interest in the property passing to Office.

With regard to the third factor, a leasehold estate is equivalent to the value of the fee interest and is not significantly affected by the obligations created by the options in the lease. Options generally obligate only one party and therefore, generally do not significantly affect the value of the equity present at the time the option is granted. Here, C is obligated to permit the lease to run for the full 69-year term, if Office within the first two and one-half years of the lease, does not exercise it option to terminate. Office, under its option to terminate, is not obligated to have any particular task completed for the benefit of C by June 30, 2001 and thus, the value of Office's equity is undiminished by the existence of the option.

Applying the above factors to the situation you pose, a change in ownership occurred at the time this lease was executed, thereby subjecting the property to reappraisal. Office's option to terminate the lease does not diminish the creation of a leasehold interest for a term of 35 years or more at the time of the lease's execution as (1) the duration of the lease term expressed in the agreement was for a term of 35 years or more, (2) the beneficial interest in the property passed to Office, and (3) the obligations created by the option to terminate do not diminish the value of Office's equity in the property.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,

/s/ Anthony S. Epolite

Anthony S. Epolite
Tax Counsel

ASE:jd
precednt/13leases/00/01ase

cc:

Mr. Richard Johnson, MIC:63
Mr. David Gau, MIC:64
Mr. Charlie Knudsen, MIC:62
Ms. Jennifer Willis, MIC:70